Sent via e-mail, fax, hand delivery
and/or U.S. Mail

July 28, 2004

Mary Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, MA 02110

Re: Petition of NSTAR Gas Company for Approval of Proposed Changes in its Gas Procurement Practices, D.T.E. 04-63

Dear Secretary Cottrell:

On June 17, 2004, NSTAR Gas Company ("NSTAR Gas" or the "Company") filed a petition with the Department of Telecommunications and Energy (the "Department") requesting authorization to modify its gas-purchasing practices to include the use of financial derivatives to further mitigate gas commodity price volatility. On July 7, 2004, the Department issued an Order of Notice that set July 28, 2004, as the deadline for submitting comments on the Company's filing. The Attorney General files this letter as his Comments.[1]

NSTAR Gas proposes to use financial derivatives in combination with its current physical gas purchases[2] in order to further reduce the Company's gas supply price volatility. Under its proposal, NSTAR Gas would purchase an additional portion (one-third) of its peak period (winter season) gas supply requirements over a twelve-month period[3] and use the weighted average price of these gas supplies in determining the price charged to customers in

[1] The Attorney General's Comments do not address all issues raised by the Company's filing. Accordingly, the lack of comment on other matters contained in the filing should not be construed or otherwise interpreted as the Attorney General's agreement, assent, or acquiescence to those matters.

[2] Under the Company's current gas procurement practices, the Company purchases approximately one-third of its peak period or winter season gas supply requirements over a seven-month period and stores those gas volumes in its underground storage facilities. It purchases those gas volumes over a seven-month period in order to reduce gas commodity price volatility. The Company purchases the remainder of its peak-season gas supply requirements on first-of-the-month or daily market prices.

[3] The Company would purchase its gas supplies on a monthly basis for the preceding twelve-month period.

the CGA during the peak period for the portion of gas purchased.[4] Unlike the gas supplies that the Company purchases for storage under its current procurement practices, the Company does not intend to take physical delivery of the gas supplies under this proposal at the time of purchase. Instead, the Company explains that it would purchase these gas supplies through financial contracts that would lock in the prices for designated volumes based on NYMEX futures prices. The Company states that it would enter financial agreements with large financial institutions in which the Company would agree to pay a fixed price for a fixed volume of gas at a point in the future. The fixed price would be based on the NYMEX futures price for each month of the coming winter season at the time the agreement is made. Under these agreements, the Company and the financial institution would reconcile the difference between the fixed price of gas and the actual market price of gas at the time of purchase.[5] The Company claims that this proposal, when combined with its current gas storage purchases, would mitigate price volatility for two-thirds of the Company's winter season usage and result in significant benefits for its customers.

While the Company's natural gas customers are likely to welcome the benefits of greater gas price stability, the Company has failed to meet its burden in demonstrating that its proposal would achieve this goal pursuant to the standards and criteria the Department established in *Risk-Management Techniques to Mitigate Natural Gas Price Volatility*, D.T.E. 01-100 (2002).[6] NSTAR Gas' letter filing provides scant information about its financial derivatives proposal.[7] The Company mentions arrangements with "large" financial institutions but does not discuss their creditworthiness or experience with financial derivatives. The Company does not provide

---

[4] The Company states that it focuses on the winter season because the highest level of price volatility typically occurs during the winter months and coincides with the cold weather and increased consumption by customers.

[5] In the Company's example, NSTAR Gas states that if in October 2005, the NYMEX futures price for gas delivered in January 2006 is $5.10/Dth, the Company would contract for a fixed volume of gas at that price. If in January 2006 the actual market price of gas purchased by the Company is $5.20/Dth, then the financial partner would pay the difference to the Company. Conversely, if in January 2006, the actual market price is $5.00/Dth, then the Company would pay the difference to the financial partner.

[6] In *Risk Management Techniques to Mitigate Natural Gas Price Volatility*, D.T.E. 01-100, p. 28 (2002), the Department established a standard of review requiring that an LDC show that a risk management plan is reasonably designed to meet the objective of price stability. The Department also directed that any risk management plan must: (1) allow customers to volunteer to participate in the plan; (2)maintain the objective of volatility mitigation and price stability rather than the objective of procuring prices below indices; (3) ensure fair competition in the gas supply market; (4) allocate all costs to program participants only; (5) demonstrate the effect that the plan would have on the reliability and transparency of commodity price; and (6) contain no incentives.

[7] Although the Company also attached a "presentation" to its two-page letter, these attachments also lack detail or analysis.

drafts or examples of any proposed financial derivative agreements that might show important contract terms and conditions. The Company has provided little or no detailed information on its supply design, size and position in the market. *See Risk Management Techniques to Mitigate Natural Gas Price Volatility*, D.T.E. 01-100, at 7. Additionally, it is unclear from the Company's filing whether NSTAR Gas is seeking authority to modify its gas-purchasing practices through financial derivatives as a pilot program that would affect only the 2005-06 winter CGA or whether the Company is seeking permanent authority. This lack of information and the absence of supporting testimony, schedules or detailed analysis does not permit meaningful review and examination of the Company's compliance with the Department's standards and directives governing natural gas price risk-management plans. *See Risk Management Techniques to Mitigate Natural Gas Price Volatility*, D.T.E. 01-100 (2002); *KeySpan Energy Delivery of New England*, D.T.E. 03-85 (2003). The Department, therefore, should reject the Company's petition or, in the alternative, commence an adjudicatory proceeding in this matter that allows intervention, discovery, hearings that include cross examination of Company witnesses to develop a complete record, and briefs.

Adjudicatory proceedings in this matter are imperative because the Company's proposal is quite different from the KeySpan proposal which the Department recently approved in *KeySpan Energy Delivery of New England*, D.T.E. 03-85 (2003).[8] Here, the Company's proposal contemplates the use of financial derivatives while in *KeySpan*, the Department noted that the company's proposal addressed only the timing of gas purchases and **not** derivatives. *Id.* at 4, n.1. The use of financial derivatives is a risky endeavor that requires appropriate skills, experience, safeguards and management oversight. The Department recognized the risky nature of financial derivatives in *KeySpan*, when despite approving KeySpan's proposal, the Department nevertheless ordered "[i]n the event [KeySpan] intends to use financial derivatives, KeySpan must seek [additional] Department approval prior to entering into this type of transactions." *Id.* at 5, n.2. The Department appropriately reviews the use of financial derivatives to mitigate price volatility on a case specific basis in unison with a LDC's supply design, size, and position in the market before it determines whether certain financial derivatives are appropriate or too risky. *Risk Management Techniques to Mitigate Natural Gas Price Volatility*, D.T.E. 01-100, at 7.

Because the Company is planning to use financial derivatives in its gas price volatility mitigation proposal, the Department should require the Company to address, at a minimum, the following issues in an adjudicatory proceeding:

(1) the methodology that NSTAR Gas would use to "lock-in" the price of up to two-thirds of its winter requirements, whether through purchases of the physical gas commodity, financial derivatives, provisions in its existing portfolio management contract, or some other third party contract;

[8] The Company erroneously suggests that its proposal is similar to the Department-approved KeySpan proposal.

(2) the policies and procedures that NSTAR Gas has in place (if any) to safeguard the Company and its customers from the risks associated with unauthorized commodities and derivatives trading that might result from the proposed modification in its gas-purchasing practices; and

(3) the policies and procedures that NSTAR Gas will have in place to ensure that the effects of the new purchasing practices will be isolated from the Company's other regulated and unregulated operations, which have shareholder incentives to profit from the trading of commodities and derivatives.

Price volatility is of concern to NSTAR Gas' customers and they would benefit from a plan that addresses their needs consistent with the Department's standards and directives governing natural gas price risk-management plans. During these unsettled times in the energy markets, the Department should not rush into accepting a proposal that is scant on information and detail. The Department, therefore, should reject the Company's petition or, in the alternative, commence an adjudicatory proceeding in this matter.

Respectfully submitted,

TOM REILLY
ATTORNEY GENERAL

By:___________________________
Wilner Borgella, Jr.
Assistant Attorney General
Utilities Division
One Ashburton Place
Boston, MA 02108
(617) 727-2200

cc: Service list